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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of 1993 Annual Access Tariff Filings	))	CC Docket No. 93-193, Phase I, Part 2
GSF Order Compliance Filings	)))	
In the Matter of 1994 Annual Access Tariff Filings	)))	CC Docket No. 94-65
In the Matter of 1995 Annual Access Tariff Filings	)))	
In the Matter of 1996 Annual Access Tariff Filings	))	

BELL ATLANTIC APPLICATION FOR REVIEW

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July 25, 1996

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BELL ATLANTIC[1] APPLICATION FOR REVIEW

Summary and Introduction

Bell Atlantic respectfully requests that the Commission review and reverse an order of the Common Carrier Bureau. The issue here concerns the resolution of a multi-year investigation of Bell Atlantic's and Pacific Bell's 1993-96 annual access tariffs and how they distributed sharing among price cap baskets. The total amount of sharing was never an issue in this investigation. The Commission's order resolving the investigation specifically directed the

[1] The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; and Bell Atlantic-West Virginia, Inc.

companies to "correct how they allocate their sharing adjustments among baskets."[2] Bell Atlantic's compliance filing did just that. Nevertheless, that filing was rejected in the Bureau order that is the subject of this application.[3]

The Bureau acknowledges that "a corrected sharing allocation for all baskets would mean that some basket indices should rise if others fall."[4] It nevertheless directed the companies to disregard that portion of the Commission's mandate and adjust only those baskets for which the indices must be reduced and make no adjustment to baskets for which the indices must be raised. Such a one-sided "correction" is inconsistent not only with the Commission's order here, but also with its price cap regulations and with a proper balancing of the equities in this investigation. The Commission should therefore overturn the Bureau order and direct the companies to make appropriate corrective adjustment to ***all*** price cap baskets.

I. Statement of the Case

A. Bell Atlantic's Tariff Filings

During the years at issue here, the Commission's rules required Bell Atlantic and other local exchange carriers ("LECs") subject to price caps to calculate a single sharing number annually based on 50 percent of the total regulated interstate earnings above 12.25 percent. Bell Atlantic's calculation of the total sharing amounts has never been disputed, and the Bureau's order does not suggest otherwise. Nor is there any question that the full amount of these sharing

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2 ***1993 Annual Access Tariff Filings***, Memorandum Opinion and Order at ¶ 39 (rel. Apr. 17, 1997) ("Commission 1993-96 Order").

3 ***1993 Annual Access Tariff Filings***, Memorandum Opinion and Order (Com. Car. Bur. rel. June 25, 1997) ("Bureau Sharing Order").

4 Bureau Sharing Order at ¶ 17.

obligations already have been distributed to customers in the form of one-time adjustments to Bell Atlantic's price cap indices.

Rather, the sole issue in this proceeding is the method used to distribute those sharing amounts among the various price cap baskets. The Commission's price cap regulations require that a sharing adjustment be made in the same manner as exogenous changes.[5] This means that the allocation of sharing among the price cap baskets must be on a "cost-causative" basis.[6] In its order addressing the 1992 access tariffs, the Common Carrier Bureau directed that this allocation be performed using the total revenues in each of the various baskets as a proxy for cost.[7] Those carriers that had not allocated their sharing obligations based upon the revenues in each of the baskets were required to revise their filings. Significantly, the Bureau specifically recognized that the impact of its decision would be to lower rates in some baskets and to raise rates in others.[8]

Consistent with this order, Bell Atlantic's 1993 annual tariff filing did allocate its sharing obligation among baskets based upon the revenues in those baskets. In performing its calculations, however, Bell Atlantic excluded end-user Common Line revenues (also known as the subscriber line charge or "SLC") from the amount of revenue assigned to the common line basket. These revenues were excluded in order to comply with Bell Atlantic's understanding of the cost causation principles applied by the Commission. Specifically, SLC revenues are based

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5 ***Policy and Rules Concerning Rates for Dominant Carriers***, 5 FCC Rcd 6786, 6801 (1990) ("Price Cap Order").

6 47 C.F.R. § 61.45(d)(4).

7 ***1992 Annual Access Filings***, 7 FCC Rcd 4731, 4732-33 (Com. Car. Bur. 1992) ("1992 Access Order"). In that order, the Bureau rejected an allocation based on basket earnings.

8 ***Id.*** at 4734.

solely on a forecasted revenue requirement, not on price cap indices or productivity adjustments.[9] Because the SLCs are capped and the revenue requirement is set to meet the 11.25% earnings benchmark, SLCs cannot contribute to earnings above that benchmark, and therefore cannot "cause" any earnings above the even higher threshold that triggers sharing obligations.[10] Because the SLC revenues in no sense cause a sharing obligation to be incurred, it was Bell Atlantic's understanding that they should properly be excluded when allocating any sharing obligation among baskets.

B. The Complaint And Investigation

AT&T objected to Bell Atlantic's exclusion of SLC revenues in its allocation of sharing obligations among the various price cap baskets. According to AT&T, excluding these revenues "overstated the sharing amounts, and understated the access rates, for Bell Atlantic's other baskets."[11] AT&T proposed its own "corrected" allocations that increased the amount of the sharing obligation that was allocated to the Common Line Basket and decreased the amount allocated to the other baskets.[12]

In response to AT&T's complaint, the Bureau suspended Bell Atlantic's rates for one day, and then allowed them to go into effect subject to an investigation and accounting order.

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9 *See* 47 C.F.R. § 61.38.

10 *See* Affidavit of William E. Taylor at ¶¶ 8-11, originally filed as an attachment to Bell Atlantic's Petition For Clarification (filed May 19, 1997) and, for the Commission's convenience, attached here as Exhibit 1 ("Taylor Affidavit").

11 ***1993 Annual Access Tariff Filings***, AT&T Opposition to Bell Atlantic Direct Cases at 28 (filed Aug. 24, 1993).

12 ***Id.***

The 1993 Order could not be more clear that the Commission was evaluating the distribution of sharing to all baskets and that any adjustment would have impact beyond a single basket. Indeed, in the very first paragraph addressing the issue, the Bureau sets out its understanding of what was subject to review:

> AT&T argues that Bell Atlantic omitted end user revenues from the common line basket revenues in violation of the 1992 Annual Access Order's requirement that sharing amounts be distributed among baskets based on their proportionate revenues. AT&T contends that Bell Atlantic's omission has a substantial effect on ***the allocation of sharing among baskets***. AT&T contends that the Commission should require Bell Atlantic to reallocate its 1992 sharing amounts, to adjust the allocation of its 1991 sharing true-ups, and ***to recalculate its price cap indices to reflect the change in the sharing allocation***.[13]

After reviewing the provisions of its 1992 order, the Commission concluded that "there is sufficient uncertainty to warrant investigation of Bell Atlantic's PCI adjustments."[14] The investigation was not confined to a single adjustment to the Common Line Basket, but instead addressed multiple adjustments that covered all of the baskets.

The investigation continued through the period in which Bell Atlantic was required to file its annual access tariffs in 1994, 1995 and 1996. Consistent with the approach taken in its 1993 filing, Bell Atlantic again excluded SLC revenues from its calculations to allocate its sharing

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13 ***1993 Annual Access Tariff Filings***, 8 FCC Rcd 4960, 4966 (Com Car. Bur. 1993) ("1993 Annual Access Order") (emphasis added).

14 ***Id.***

obligations among baskets. AT&T objected to each of these filings.[15] In each instance, AT&T recalculated the sharing amounts allocated to each basket to reflect an upward adjustment in the amount allocated to the Common Line Basket and a downward adjustment in the amount allocated to the three remaining baskets.[16]

As it had with 1993 tariff filing, the Commission responded to each of AT&T's complaints by folding the issue of how the sharing was distributed for each of the subsequent years into the existing 1993 investigation.[17]

Nowhere in the record for all four years was there ever a suggestion -- by AT&T, the Bureau, the Commission, or any other party -- that Bell Atlantic did not share the correct amount. Both Bell Atlantic and AT&T were clear that the issue before the Commission was a question of how the given amount of total sharing should be distributed among the baskets, not how to determine the total amount to be shared in the first instance.

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[15] In 1994 and 1996, AT&T's complaint concerning the allocation of sharing was joined by one other party. In each instance, the additional party merely referenced the existing investigation concerning the allocation of sharing among baskets. Neither of these additional parties ever suggested that the resolution of their complaint would involve an increase in the total amount shared. ***1994 Annual Access Tariff Filings***, Allnet Communication Services, Inc. Petition To Suspend For One Day and Investigate (filed Apr. 26, 1994); ***1996 Annual Access Filings***, Sprint Communications Co. Petition to Reject or Alternatively Suspend and Investigate (filed Apr. 29, 1996).

[16] Attached as Exhibit 2 is AT&T's calculations excerpted from each of these filings.

[17] ***1994 Annual Access Filings***, Memorandum Opinion & Order, 9 FCC Rcd 3705, 3715 (1994); ***1995 Annual Access Filings***, Memorandum Opinion & Order, 11 FCC Rcd 5461, 5488-89 (1995); ***1996 Annual Access Filings***, Memorandum Opinion & Order, 11 FCC Rcd 7564, 7580 (1996).

C. The Commission's Order

In its order concluding the investigation, the Commission found that Bell Atlantic and Pacific "incorrectly allocated their sharing obligations ***among*** the various service baskets."[18] The 1993-96 order does not require that Bell Atlantic recalculate its total sharing obligation (nor could it since the issue was never raised). Instead, the order requires Bell Atlantic to "correct" the manner in which it allocated its sharing obligation "***among***" baskets.

Despite the clear requirement that Bell Atlantic must reallocate sharing "among" the baskets, and not limit its adjustment to any one basket, the order introduced some confusion because the more specific instructions set out at the end of the order spoke only of how to "implement refunds."[19] Consequently, to remove any doubt about what was intended, Bell Atlantic petitioned for a clarification of the Commission's order.[20]

D. The Bureau's Order

In the order under review here, the Bureau determined that Bell Atlantic must reduce the price cap index for its Common Line Basket to account for the previous under-allocation of Bell Atlantic's sharing obligation to that basket. At the same time, it barred Bell Atlantic from adjusting the price cap indices for any other baskets to account for the corresponding over-allocation of Bell Atlantic's sharing obligation to those other baskets. As a result, Bell Atlantic has begun to refund over $34 million in the current tariff year.[21]

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18 Commission 1993-96 Order at ¶ 39 (emphasis added).

19 ***Id. See also Id.*** at Section V.

20 Bell Atlantic Petition for Clarification (filed May 19, 1997).

21 ***See*** Bell Atlantic Transmittal No. 977 (filed June 30, 1997).

In reaching its conclusion, the Bureau did not dispute that Bell Atlantic had already shared the correct amount at the time of the actual tariffs. It also recognized that "a corrected sharing allocation for all baskets would mean that some basket indices should rise if others fall."[22] It nevertheless found that "the equities or balancing of interests in this case" do not allow for a correction to the other baskets.[23]

The Bureau's decision is inconsistent with the Commission's price cap regulations and the Commission's prior order in this matter. Moreover, based on the undisputed facts, the penalty imposed by the Bureau's order is incompatible with a proper understanding of the equities.[24]

II. A Partial Correction Would Be Inconsistent With the Commission's Own Price Cap Rules

By requiring an adjustment only to the Common Line Basket, the Bureau's order fails to correct the allocation of Bell Atlantic's sharing obligation among baskets, and instead merely increases the amount that Bell Atlantic must share in the Common Line Basket without permitting corresponding reductions in the amount shared for the other baskets. Despite the fact that the total sharing amount was never in dispute, this would have the effect of increasing the total amount of Bell Atlantic's sharing for the years in question.

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22 Bureau Sharing Order at ¶ 17.

23 Bureau Sharing Order at ¶ 18.

24 In particular, Commission action is warranted here because the Bureau's order: i) is in conflict with "regulation, case precedent" and "established Commission policy;" ii) involves a question of law or policy which has not previously been resolved by the Commission; and iii) involves a "policy which should be overturned or revised." 47 C.F.R. § 1.115 (b) (2).

While the Commission has the right to order a refund for a rate that was under timely investigation and found to be unlawful, such a refund must be consistent with the Commission's then existing rules and regulations. A refund that would "contradict the Commission's own theory" of regulation is unlawful.[25] Here, the Bureau made no effort to reconcile its order with the Commission's price cap regulations. In fact, the order is inconsistent with these regulations in at least four respects.[26]

First, the sharing plan has a "'50-50 sharing zone' wherein LECs complying with price cap regulation will be required to share with consumers 50 percent of their earnings between 12.25 percent and . . . 16.25 percent."[27] If the redistribution of sharing amounts is made only to the Common Line Basket, the total amount that Bell Atlantic is required to share will increase to a point well above 50% of its earnings within the sharing range -- more than a 27% increase in sharing obligations for the most recent year under review.[28]

Second, the sharing mechanism "operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings."[29] Bell Atlantic distributed the full amount of its sharing obligation for the years in question. Any requirement that Bell Atlantic refund additional sharing dollars without an offsetting adjustment to other baskets means that Bell Atlantic will be obliged to share a second time for past years' earnings.

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25 ***AT&T v. FCC***, 836 F.2d 1386, 1392-93 (D.C. Cir. 1988).

26 ***See also*** Taylor Affidavit at ¶¶ 13-20.

27 Price Cap Order at 6801.

28 Attached as Exhibit 3 is a workpaper that calculates the percentage of earnings that Bell Atlantic is required to share under the Bureau's order.

29 Price Cap Order at 6803.

Third, the sharing mechanism "is created as a backstop to the [price cap] plan as a whole, not to individual rates or even basket earnings levels."[30] "The plan stresses LEC overall productivity, and the sharing mechanism is keyed to that unified approach."[31] If the Commission were to require a redistribution to one basket, but not to others, Bell Atlantic would have different sharing requirements for different baskets in violation of this principle.

Finally, changes in the price cap levels are to be based on exogenous cost changes, inflation or expected productivity growth.[32] Indeed, at the same time the ordered refund went into effect, Bell Atlantic also significantly reduced rates to reflect the Commission's mandated increase in the price cap productivity factor.[33] It would be inconsistent with price cap regulation in general, and the Commission's price cap reform decision in particular, to require a significant ***additional*** reduction based on prior years' sharing obligations when all parties must concede that the correct sharing amount was distributed in full in a timely fashion.[34]

III. The Bureau's Decision Is Inconsistent With A Balance Of The Equities

Even assuming that the Commission lawfully could require the sharing amounts to be reallocated only in part, the Bureau decision does not suggest that it was compelled to reach that result. Rather, it acknowledges that it is a matter of discretion that is based on a balancing of

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30 ***Policy and Rules Concerning Rates for Dominant Carriers***, Order on Reconsideration, 6 FCC Rcd. 2637, 2679 (1991) ("Price Cap Reconsideration Order").

31 ***Id.***

32 ***See*** 47 C.F.R. § 61.45.

33 Bell Atlantic Transmittal No. 977 (filed June 30, 1997).

34 ***See*** Taylor Affidavit at ¶¶ 14-15.

equities. In reality, even relying on just the issues looked at by the Bureau, the equities in this case can not support the penalty that was imposed.

Although the Bureau begins its analysis by looking at what it characterizes as a "similar situation" in the 800 Data Base Reconsideration,[35] it nonetheless concedes that the "considerations in the present case [are] different from those addressed by the Commission in the 800 Data Base Reconsideration."[36] In that case, after an ordering a reduction in price cap indices, the Commission rejected carriers' attempts to take prospective advantage of headroom that they had forgone in the past.[37] That is simply not the situation here. Bell Atlantic does not seek to make a prospective adjustment for past headroom that it had voluntarily foregone. Rather, the correction ordered by the Commission only now creates the additional headroom in some baskets. Moreover, Bell Atlantic limited its proposed adjustments to those changes required to correct what the Commission's investigation concluded was an error. There is no precedent that suggests that the Commission may not prospectively adjust indices in any direction to reflect the outcome of an investigation that was begun at the time the rates went into effect.

Similarly, the Bureau cites ***FPC v. Tennessee Gas Transmission Co.*** to support its decision.[38] In ***Tennessee Gas***, the Power Commission overturned a price increase, and required

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35 Bureau Sharing Order at ¶ 15.

36 ***Id.*** at ¶ 17.

37 ***800 Data Base Access Tariffs***, CC Docket No. 93-129, Order on Reconsideration at ¶17 (rel. Apr. 14, 1997).

38 Bureau Sharing Order at ¶ 16.

the carrier to refund amounts it already had received through the increased rates.[39] The carrier sought to offset the required refund with an unrelated increase in other rates, to achieve its overall authorized return. The Court found that it would violate the filed rate doctrine to attempt to recoup the refund on one rate by a retroactive increase in a separate rate.[40] Thus, unlike the situation here, the subject of dispute was the level of specific unrelated ***rates*** following an unlawful price increase. Here, the issue was a reduction of price ***indices*** to reflect a sharing obligation where the overall level of sharing was not in dispute. Rather than seek to offset a refund with an unrelated rate increase, Bell Atlantic proposes only to make a single adjustment to reallocate its sharing obligation correctly, and to treat all baskets alike in assessing the impact of that change. To the extent an index for one basket is changed, it necessarily produces a ***related*** and corresponding change to indices for other baskets.

Without discussion, the Bureau also concludes that "nothing in our previous designation orders covering this issue places customers on notice that they could be subject to prospective rate increases on account of sharing misallocations."[41] As documented above, this conclusion is inconsistent with the actual language of the original designation order. The Bureau was explicit in that order that the question before it was whether Bell Atlantic must "recalculate its price cap ***indices*** to reflect the change in the sharing allocation."[42] That is exactly what the Commission determined that Bell Atlantic must do, and customers have no basis to claim they lacked notice

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39 ***Federal Power Commission v. Tennessee Gas Transmission Co.***, 371 U.S. 145, 147-48 (1962).

40 ***Id.*** at 153.

41 Bureau Sharing Order at ¶ 18.

42 1993 Annual Access Order at 4966 (emphasis added).

of that outcome. Indeed, Bell Atlantic's largest customer, AT&T, specifically requested that ***all*** baskets be adjusted.[43]

The Bureau also reasons that regardless of notice, "there is no guarantee that those customers that benefited from the reduced rates arising from the misallocation would be the same ratepayers paying the proposed offset."[44] But of course this is true whenever current indices are adjusted to correct past events. The customers that benefit from the reduced Common Line Basket under the Bureau's order may not be the same customers as four years ago. In fact, because Bell Atlantic's access business then and now is dominated by the three largest carriers, there must, at a minimum, be a large overlap in customer identity. Those customers are now receiving a windfall under the Bureau's order. Moreover, customers in the other baskets also pay a CCL charge, so that the net effect for a full correction of the sharing allocation is that such customers would come out even, regardless of whether or not they were around in 1993.

The Bureau also places weight on its conclusion that Bell Atlantic and Pacific Bell "chose to disregard" the directive in the Bureau's 1992 access order that sharing be calculated on the basis of "total basket revenues."[45] In fact, the companies were faced with a choice among conflicting interpretations of what was required. Had Bell Atlantic originally included SLC revenues in its distribution calculation, it could have been subject to a claim that it was violating the requirement that the calculation be done on a cost causative basis.[46] As Dr. Taylor

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43 ***See*** Exhibit 2.

44 Bureau Sharing Order at ¶ 18.

45 Bureau Sharing Order at ¶ 16.

46 47 C.F.R. § 61.45(d)(4).

demonstrates, the effect of that methodology is to "weight ***dis***proportionately the remaining services in the common basket, namely the CCL charge."[47]

Indeed, the Commission itself did not make an immediate finding of a violation of the 1992 order, but instead concluded that "there is sufficient uncertainty to warrant investigation of Bell Atlantic's PCI adjustments."[48] That investigation took four years. Had the Commission concluded its investigation within the fifteen month statutory period, Bell Atlantic's sharing during that period was so small that its liability would have been approximately one tenth of the refund amount that resulted from the later order.[49]

Conclusion

The Commission should clarify its original order, reverse the Bureau's interpretation, and mandate that any correction of the 1993-96 sharing distribution be made to the indices for all price cap baskets.

Respectfully submitted,

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July 25, 1997

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47 Taylor Affidavit at ¶ 10.

48 1993 Annual Access Order at 4966.

49 The liability for that period was $3.5 million (25% of the sharing redistribution liability associated with the 1994/95 tariff period). ***See*** Exhibit 3.

EXHIBIT 1

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

In the Matter of	)	**CC Docket No. 93-193**
1993 Annual Access Tariff Filings	)	**Phase 1, Part 2**
	)	
GSF Order Compliance Filings	)	
	)	
In the Matter of	)	
1994 Annual Access Tariff Filings	)	**CC Docket No. 94-65**
	)	
In the Matter of	)	
1995 Annual Access Tariff Filings	)	
	)	
In the Matter of	)	
1996 Annual Access Tariff Filings	)	

AFFIDAVIT OF WILLIAM E. TAYLOR

1. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. My business address is One Main Street, Cambridge, Massachusetts 02142.

2. I have been an economist for over twenty-five years. I received a B.A. degree in economics (Magna Cum Laude) from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in Economics from Berkeley in 1974, specializing in industrial organization and econometrics. I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, and telecommunications policy at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts

Institute of Technology) and at research organizations in the telecommunications industry (including Bell Laboratories and Bell Communications Research, Inc.). I have participated in telecommunications regulatory proceedings before state public service commissions and the Federal Communications Commission ("FCC") concerning competition, incentive regulation, price cap regulation, productivity, access charges, pricing for economic efficiency, and cost allocation methods for joint supply of video, voice and data services on broadband networks. A copy of my vita was provided as an attachment to my affidavit filed on behalf of Bell Atlantic and other parties in CC Docket No. 96-46 on April 26, 1996.

I. BACKGROUND AND SUMMARY

3. In its Memorandum Opinion and Order in CC Docket Nos. 93-193 and 94-65,[1] the FCC resolved most of its open investigations of price cap issues arising in the four annual access filings that have occurred since 1993. Among other things, the *1993-96 Access Tariff Order* found that Bell Atlantic allocated its earnings sharing adjustment to its price cap baskets incorrectly. The price cap rules specify that the customer share (including interest) is to be refunded through a one-time reduction in the PCI for the next rate period, calculated in the same manner as other exogenous changes.[2] Section 61.45(d)(4) of the Commission's Rules specifies that exogenous changes should be allocated among the four price cap baskets on a "cost-causative" basis. The *1993-96 Access Tariff Order* found that Bell Atlantic's allocation—based on revenue from carrier access services (omitting subscriber line revenue)—was incorrect in its annual filings for 1993 through 1996. As a result, the *1993-96 Access Tariff Order* directs Bell Atlantic to correct its allocation, revise its indices and implement refunds so that its pricing limits

[1] In the Matter of 1993 Annual Access Tariff Filings, GSF Order Compliance Filings, 1994 Annual Access Tariff Filings, 1995 Annual Access Tariff Filings, 1996 Annual Access Tariff Filings, *Memorandum Opinion and Order*, CC Docket Nos. 93-193 (Phase 1, Part 2) and 94-65, released April 17, 1997 (the "1993-96 Access Tariff Order").

[2] Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order* 5 FCC Rcd at 6801 (1990) ("LEC Price Cap Order").

reflect the corrected allocation and overcharges relative to those limits are refunded to customers.[3] The specific adjustments outlined in the Order, however, do not accomplish these goals.

4. From an economic perspective, Bell Atlantic's method of allocating its sharing adjustment among baskets in its 1993 to 1996 tariffs was reasonable and returned the proper sharing amount—half its earnings between 12.25 and 16.25 percent—to its interstate customers. In addition, Bell Atlantic's allocation method appears to have been consistent with the Commission's *1992 Annual Access Order* because it allocated adjustments to price limits proportionally across services on a cost causative basis, rather than targeting reductions to services according to productivity growth or other criteria. The Commission has concluded, however, that Bell Atlantic's allocation method was wrong and should be corrected. The purpose of this affidavit is not to second guess that conclusion. Rather, this affidavit explains from an economic standpoint, the proper way to correct the sharing allocation to comply with the Commission's order in order to ensure that the correct amount is shared with interstate customers and the efficiency incentives established in the price cap plan are preserved.

5. As I explain below, implementing the *1993-96 Access Tariff Order* should entail no aggregate refund obligation for Bell Atlantic because interstate customers, in total, already received precisely the earnings sharing adjustment to which they were entitled. The *1993-96 Access Tariff Order*, however, sets out a method for calculating a refund liability for baskets that received too little sharing adjustment; but does not specify how to calculate the offsetting effect for the baskets that received too much. If the order were interpreted—incorrectly from an economic perspective—to mean that Bell Atlantic should incur a liability for its incorrect under-allocation of the earnings sharing adjustment to the common line basket but not offset that liability with the incorrect over-allocation of the earnings sharing adjustment to the three other price cap baskets, such an interpretation would be inconsistent with the Commission's price cap

[3] *1993-96 Access Tariff Order*, ¶ 39. Two adjustments are required to Bell Atlantic's PCIs, SBIs and maximum CCL rate: (i) a permanent adjustment to correct its PCIs (and other pricing limits) "so that those PCIs are what would have been in place had they been calculated consistent with the Commission's rules and decisions" [*1993-96 Access Tariff Order* at ¶ 97] and (ii) a one-time adjustment to "refund to [its] customers all amounts, plus interest, collected as a result of overcharges." [*1993-96 Access Tariff Order* at ¶ 104].

rules since it would require Bell Atlantic to share more in total than is required, and would represent bad economic policy. The economic consequence would be bad for customers because changes in the price cap rules after the fact would undercut the incentives the regulated firm has under price caps to lower costs, expand demand and (generally) to increase productivity growth. It would also mean that some customers would receive an unwarranted windfall since the correct amount has already been shared with customers.

II. BELL ATLANTIC'S PREVIOUS ALLOCATION WAS CONSISTENT WITH THE ECONOMIC PRINCIPLES UNDERLYING THE COMMISSION'S *1992 ACCESS TARIFF ORDER* AND RETURNED THE CORRECT SHARING AMOUNT TO CUSTOMERS.

6. In 1990, the FCC adopted a price cap plan for the regulation of the interstate services of local exchange carriers. The plan identified four baskets of services (common line, traffic sensitive, special access and interexchange) and adjusted four price cap indices independently (one for each basket) using a formula that combined national inflation, a single productivity offset (**X**) and adjustments for exogenous changes in costs.[4] By replacing traditional rate of return regulation with price cap regulation, the Commission sought to correct the incentives under which regulated local exchange carriers operated, essentially breaking the link between accounting costs and service prices. At the same time, the Commission instituted an earnings sharing and backstop mechanism to mitigate the efficiency losses from possible differences in prices and costs and to introduce a self-correcting mechanism into the plan.

7. The earnings sharing and backstop mechanism was triggered by earnings for the aggregate of all interstate services in all four price cap baskets. Over-earnings were returned by a one-time (one year) reduction in the PCI for each basket, where the sharing amount was to be allocated to each basket on a "cost-causative" basis, in the same manner as other exogenous cost changes were allocated to baskets. For general exogenous cost changes, the economic intent of this requirement was to tie as tightly as possible exogenous changes in costs for a service to

[4] The plan also identified service categories and subcategories within baskets whose price changes were limited by upper and lower price bands around a subindex of prices called the Service Band Index ("SBI") which moved with the PCI change for each basket.

changes in price for that service, so that, for each service, prices and exogenous costs would move together. Similarly, for the special case of sharing, assignment of the total amount to each basket on a cost-causative basis is also desirable because it tends to move service prices in each basket as costs change in that basket.

8. In its *1992 Access Tariff Order*, the Commission determined that revenues in each basket could be used as a proxy for costs in each basket: "because rates are set based on costs, revenue should equal costs." From this reasonable approximation, the Order concluded that, because revenues in each basket approximately equal costs in each basket, allocating exogenous cost adjustments to the baskets by revenue was, in effect, an allocation on a cost-causal basis.[5] Because price limits for the different baskets will generally move in proportion to the change in costs, such an allocation broadly comports with the economist's notion of a cost-causal allocation.

9. While this method is generally correct, the common line basket requires special treatment under the assumptions of the *1992 Annual Access Order* in order that a revenue-based allocation achieve a cost-causative result. The issue here is different from that addressed in the *1992 Annual Access Order*. In that Order, the Commission declined to allow price cap LECs to target sharing allocations to baskets depending on the degree to which services in the basket contributed more or less to the productivity growth that led to the earnings sharing adjustment. The Commission determined that productivity growth in all interstate services is responsible for an aggregate earnings sharing requirement and therefore that all interstate services should benefit proportionately from the sharing adjustment.[6] Given, then, that the objective of the allocation method is to reduce price ceilings for all interstate services in the same proportion, the common line basket requires special treatment if sharing amounts are to be allocated correctly from an economic standpoint.

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[5] *1992 Annual Access Order*, 7 FCC Rcd at 4733. As the Common Carrier Bureau noted, "allocating sharing and low end adjustments on the basis of relative basket revenues most closely comports with the goals of the Commission's price cap plan" and that such an allocation is consistent with the requirement that the sharing obligation be calculated on the basis of total interstate earnings: *1992 Annual Access Order* 7 FCC Rcd at 4732-33.

[6] *Ibid.*

10. The problem is that the common line basket recovers costs associated with a single network element (the loop) but historically has contained rates for two different services. End users have paid subscriber line charges ("SLCs") on a monthly basis for each of their lines, while interexchange carriers have paid the carrier common line ("CCL") charge for every minute of interstate switched access. A second problem is that the SLCs are separately capped under the price cap plan and cannot move as the PCI for the common line basket moves. Thus, changes in the common line PCI do not impact common line services equally; rather, they impact only the CCL and the price interexchange carriers pay for switched access service. Given the constraint on the SLCs, the object of any allocation of sharing adjustments to the baskets should be to approximate as closely as possible, the prices (or price limits) for services that would pertain if there were no restrictions on the SLCs. Since, by assumption, the sharing adjustment reflects a reduction in costs of all services by the same proportion, we would like to see equal proportional reductions in prices (or price limits) for all services. Such an allocation would minimize the distortion caused by the constraint that SLCs neither rise nor fall in response to changes in costs.[7] In contrast, the effect of allocating a sharing adjustment on the basis of total common line revenue would be to weight <u>dis</u>proportionately the remaining services in the common line basket, namely the CCL charge.

11. Consider a 10 percent exogenous cost change—like a sharing adjustment—that reflects a proportional reduction in all costs and should therefore reduce all price limits proportionally. Suppose, for simplicity, the revenue share of each basket was 25% and half the common line basket corresponded to SLC revenue and half to CCL revenue. If the reduction were allocated across the price cap baskets using all revenues (including SLC revenue), PCIs would fall by 10 percent in each basket. However, <u>prices</u> would not change in those proportions because in the common line basket, the CCL would fall by 20 percent and SLCs would remain

[7] This is the economic reason that deviating from an allocation based on total common line basket revenue is the correct approach. It is *not* an attempt to allocate the sharing adjustment disproportionately to baskets following some notion of disproportionate responsibility for productivity growth (which was rejected in the *1992 Annual Access Tariff Order*). Rather, it is a necessary adjustment in the allocator to achieve what was ordered in the *1992 Annual Access Tariff Order*: an equiproportional flow-through of the earnings adjustment to all interstate services.

constant. This reduction would distort the relationship among prices and costs across the price cap baskets: for example, switched access prices would fall by more than 10 percent while special access prices would fall by exactly 10 percent. Under these assumptions, assigning the exogenous cost change to baskets by revenue is not cost-causative and potentially distorts interexchange carriers' choices of access services. In contrast, if SLC revenues are ignored in the allocation, the CCL and the PCIs for the remaining (non common line) baskets fall by the same amount (11.4 percent of revenues less SLC) so that the requirement that SLCs remain unchanged does not distort the proportional price reductions among services in different baskets, such as switched and special access.

12. As the above discussion demonstrates, the method employed by Bell Atlantic to allocate sharing was reasonable from an economic standpoint, was consistent with the previous Commission determination that an earnings sharing adjustment should be spread proportionally across all services, and was also consistent with the objectives of the Commission's price cap rules. Given that Bell Atlantic's method of assigning the sharing adjustment on a cost-causative basis has been determined to be incorrect, the question has become one of how its PCIs, SBIs and CCL should change to correct the errors in the 1993-1996 filings and how refunds of overcharges—if any—should be calculated and implemented.

III. ONE-TIME CHANGES TO REFUND OVERCHARGES ARE UNWARRANTED.

13. Subsection C of the *1993-96 Access Tariff Order* sets out only part of the required calculations to correctly determine the amount of any "refund to ... customers all amounts, plus interest, collected as a result of overcharges."[8] Basically, the portion of the calculation included in the order would classify a customer as "overcharged" if, at half-year periods from 1993 through 1996, any API exceeds its corresponding PCI, any SBI exceeds its upper limit or any CCL rate in effect exceeds the maximum CCL rate. The order does not, however expressly set out the rest of

[8] *1993-96 Access Tariff Order* at ¶ 104.

the calculation required to correctly determine the amount of any overcharge to be refunded through a 1997 one-year exogenous cost change.

14. To fully adjust for the change in allocation method, the Commission must include an equivalent adjustment to reflect the amount of sharing over-allocated to the remaining three baskets. Each basket, calculated independently, should have a one-time adjustment to its PCI, to reflect such a change.[9] While the customers for services in those baskets also pay CCL charges, they benefited from the additional sharing that was allocated to them by virtue of the exclusion of end-user revenues in Bell Atlantic's original allocation to the CCL Basket. If the Commission has determined that Bell Atlantic should be required to correct for the impacts of such exclusion, all such impacts must be addressed. To do otherwise, as explained below, would be to distort the final sharing amounts so that they would not be consistent with the Commission's revised allocation method, or with the price cap rules in general.

A. Performing only a partial calculation would distort the incentives in the price cap plan.

15. In contrast to the correct method for reconstructing Bell Atlantic's indices, performing only the portion of the calculations set out in the order would effectively require Bell Atlantic to share a larger portion of its earnings in each of the years 1993 through 1996 than the amount called for in the price cap plan. It is generally recognized that the sharing of earnings has deleterious effects on the incentives for regulated firms to reduce costs and expand output.[10] To the extent that the refund calculation were performed in a way that increases the sharing obligation of the regulated firm, it reduces the firm's incentives to undertake activities that increase earnings. In addition, the fact that the refund calculation treats interstate services asymmetrically—reducing switched access price limits more than proportionately and special access and interexchange price limits less than proportionately—further distorts incentives from

[9] The result may be to create additional distance between the PCI and the API for those baskets. Consistent with the price cap rules, a carrier is free to adjust its prices up or down, so long as they do not exceed the PCI.

[10] Indeed, earnings sharing has been eliminated in the price cap plan changes announced by the FCC on May 7.